Introduction

- A small apartment and miniwarehouse developer in a medium-sized city in the East has been caught in the worst real estate depression since the 1930s. He faces an overbuilt market. His recently built projects are draining his cash. His banks are not only not lending, they are threatening to pull his existing line of credit. With development fees and the sale or refinancing of his built projects as his sole source of cash flow, this developer is facing corporate bankruptcy and, even worse, personal bankruptcy because he has personally guaranteed much of the company debt.
- Having refinanced its 1 million-square-foot portfolio of industrial property, a medium-sized real estate company in a Southeastern metropolitan area noted a gradual upturn in its market. Build-to-suit projects for corporations were being developed in large numbers. The values of existing industrial projects had been rising for the last two years due to vulture fund and real estate investment trust (REIT) activity. The company's top management was beginning to talk about the possibility of returning to speculative development. The company also had extensive leasing and property management operations, not just for its own projects but also for third parties. The income from these operations had covered the firm's overhead for the last few years. Now that development activity seemed feasible in the near future, the firm's management was trying to decide how to position the company to take advantage of an improving market.
- Due to the strength of the real estate market, a large, diversified, full-service real estate company serving seven metropolitan areas in the Western United States had successfully expanded its development activities

for a number of years. Recently, however, it has placed less emphasis on its fee management business in favor of its burgeoning development activity, which took most of the firm's capital and attention. While the firm's recent projects appear to be successful and its projects in the pipeline hold great promise, the top managers remember the last real estate depression all too well. They are concerned that if the economic growth in their region slows down, they might be caught with underperforming new projects and insufficient cash flow from fee businesses. Even though their preference is to continue developing, the managers have an intuitive sense that they should shore up their foundation just in case their markets become soft.

These are examples of real estate companies facing strategic challenges at crucial points in the economic cycle. Each company is attempting to determine its future direction and how it plans to get there. The only question is whether the firms' top managers will consciously look at their economic situation and explore all the available options or whether they will unconsciously decide simply to muddle through. Most firms in our business follow the latter course.

This book is an introduction to strategic planning for income property real estate companies, both large and small. It is a primer on the most important issues real estate senior management faces: how to set the direction of the firm and implement an action plan to ensure that the strategy is pursued.

The income property real estate industry is defined as the development and management of income-producing assets, including product types such as office, retail, industrial, and office parks; hotels and rental apartments; and smaller segments such as miniwarehouses, recreational facilities, etc. The income property real estate industry does not include for-sale residential property. That segment of the industry is a much different type of business, from its organizational structure to its financing, and thus deserves its own special approach.

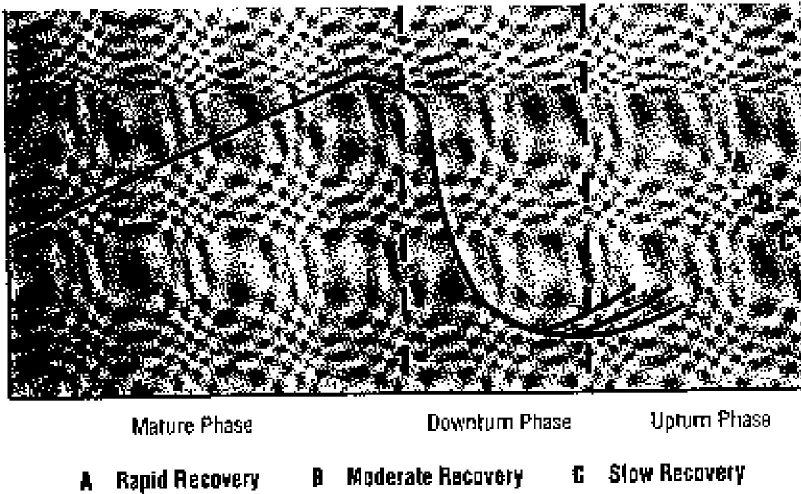
Income property real estate is one of the largest segments of the national economy. It is also the most cyclical industry in the economy. It experiences higher highs and lower lows than nearly any other industry, including the automobile, aerospace, and other highly cyclical industries. More than any other factor, the real estate cycle determines the strategy of any income property company. When formulating a strategy, a company *must* start with an understanding of the effect of these extreme cycles.

The real estate cycle comprises three general phases as shown in Figure I-1 and discussed below.

- *Upturn*—Lasting one to two years, the upturn is one of the rare times when it is a "seller's" market for leasing income property. After a metropolitan area's vacancies fall to the 5 percent to 10 percent range in re-

Figure I-1

Real Estate Cycle



Source: Robert Charles Lesser & Co.

sponse to a general economic recovery, the usual result is rising demand for space. Yet the lead time required for developers to respond to this demand is too long to produce the needed new space. Consequently, managers allow rents of existing space to rise while they reduce or eliminate concessions.

- *Mature*—Lasting anywhere from two to five years, the mature phase is a time of approximate equilibrium. Toward the end of the mature phase, however, it is not unusual for an increasing amount of new space to come onto the market, causing a virtual overnight shift to a "buyer's" market. The increased supply forces owners to lower rents and increase concessions. Despite rising vacancies and falling rents, unduly optimistic projections about the future performance of new projects generally keeps the pipeline full of additional new space, unless financial institutions and investors demand increased preleasing and more conservative absorption and rental rate assumptions in the pro forma.
- *Downturn*—Usually lasting from two to four years, although Texas experienced a nearly decade-long downturn in the 1980s, the downturn is a period of adjustment when falling demand and excess capacity force drastic concessions and lowered rents. The result is the bankruptcy of

marginal projects and a serious decline in the financial performance of nearly every project in the market. The bankruptcy of many developers, coupled with unduly pessimistic future demand projections by bankers and investors hurt by the downturn, prevents the development of any new product well beyond the period of the downturn, thus setting the foundation for the next upturn.

Undue optimism *and* pessimism are both major factors in the extreme cyclical nature of the industry. For example, in the early 1990s, many industry observers and participants predicted a paralysis in the industry for years to come. They believed that new income real estate would not be built before the turn of the century. Conversely, during the 1980s boom, many industry observers and participants believed that the good times would never end.

Such unbridled optimism or pessimism is almost always misplaced. Markets always correct themselves on both the downside and the upside. The form of the industry may change over time as may the sources and mechanisms of financing and the structure of the companies within the industry. But the ever-changing American economy and the radically transforming size and shape of our metropolitan areas, not to mention the continued obsolescence of older buildings, guarantee that the industry will always emerge from downturns—no matter how crushing.

In the preparation of a strategic plan, it is crucial to identify the phase of both the current cycle and that likely to characterize the next two to three years. A realistic assessment of the market is essential in developing an appropriate and optimal strategy.

This book is organized into three sections. The first section (Chapters 1 and 2) is an in-depth discussion of the real estate cycle and the balanced portfolio approach a real estate company can use to manage the cycle's upturns and downturns successfully. The second section (Chapters 3 through 7) outlines the universe of strategic options available to companies in the industry. It discusses the major issues companies must face as they develop a strategy. The third section (Chapters 8 through 10) discusses financing the strategy and how to develop a strategic plan. It concludes with some thoughts on the future of the industry. Finally, the appendices offer three case studies of companies adjusting to the new realities of the 1990s.

Never have the challenges facing companies in the real estate industry been as great as they are in the mid-1990s. As John F. Kennedy noted in 1959, "When written in Chinese, the word 'crisis' is composed of two characters—one represents danger and the other represents opportunity." This certainly applies to the income property real estate industry as it meets the demands of the 1990s marketplace.

Chapter 1

Real Estate Cycles And Roles

The cruel truth about the cyclical nature of the income property industry must be the starting point for any discussion of strategic planning. To ignore the extreme cyclicality of the industry is to place a company at peril, dooming it to continuous crisis during every real estate depression. If companies do not adequately plan for deep downturns, they will never survive to enjoy the inevitable upturns.

Many factors contribute to the industry's extreme overreaction to economic trends. These include

- the relationship between fixed and variable costs that is built into the industry's finances;
- the long-term nature of the customer commitment;
- the lead times required to develop new product; and
- the unfounded optimism that pervades the industry.

Taken in combination, these factors guarantee that when a metropolitan economy catches a cold, the income property development industry catches pneumonia. Many participants in the industry, including investors and lenders, quickly succumb.

Fixed and Variable Costs

The relationship between fixed and variable costs is one of the primary reasons for the extreme cyclical nature of the industry. Affecting every income property type, the fixed costs of a leveraged new development account for approximately 70 percent of break-even revenues. In other words, the debt service of a new office, hotel, or rental apartment project represents most of that project's costs, assuming the development breaks even. The

variable costs associated with running the building, i.e., property management, maintenance, utilities, taxes, etc., amount to only about 30 percent of break-even revenues.

The airline industry operates under a similar financial structure. The fixed costs of financing the aircraft represent most of the airlines' break-even costs, thereby exposing the industry to short-term price wars with fares priced well below the break-even point. The airline industry price wars are the direct result of excess capacity.

The same phenomenon affects income property real estate. During times of overcapacity, it makes short-term economic sense to price space well below the break-even point. In the airline industry, once a seat is flown empty, the revenue for that seat is lost forever. So, too, with income property real estate. Every day office space is not leased or a hotel room goes unrented, the income for that day is lost forever. Therefore, any rent above the variable costs, i.e., any rent above 30 percent of the break-even point, is better than no rent for vacant space. Thus, during the depths of the late 1980s downturn, some office markets saw $8 to $12 per square foot (gross) rents for new space when $18 to $24 per square foot rents were needed to break even.

Conversely, firms can realize generally high rents and occupancy rates during the upturn phase of the cycle and thus considerable profits. Once the break-even point is reached, 70 percent of every dollar of rent drops to the bottom line.

Long-Term Customer Commitment

The second factor that affects the industry's overreaction to economic trends is the long-term customer commitment required by most income property products. For example, the typical office and industrial lease is five years in duration. Many of the larger leases are 10 years and longer. Of course, there are exceptions—such as hotels, rental apartments, and mini-warehouses—which may not be able to obtain a customer commitment of more than a month or even a day.

When a regional economy falls into a recession, many companies in a metropolitan area face a short-term threat to their viability. Because of economic or psychological reasons or both, it is difficult for a current or prospective tenant to consider a relatively long-term commitment such as a five- to 10-year lease.

If a company's lease is coming due during an economic downturn, it may tend to be conservative about the amount of space it requires. It does not lease any more space than needed and may even shed surplus space, thus creating a large "shadow" market in sublease space. The shadow market may be as much as one-half of the known vacant space glutting

the market during a downturn. For example, assuming an "official" 20 percent office vacancy rate during the trough of a downturn, the shadow market could account for as much as 10 percent additional vacancy. As the regional economy improves, however, businesses become more sanguine about their future. Long-term lease decisions are easier to justify, and companies rent a more generous amount of space for both current use and future expansion.

Lead Time for New Product

A third reason for the industry's extreme overreaction to economic trends is the lead time required to bring new product on line. On the one hand, the transition from too little space to too much space can occur almost overnight through a change in perception of the market reality. At a 1986 meeting in Kenneth Leventhal's Century City office, John Cushman, a leading office leasing agent in the country during the 1980s, remarked that he felt that the office market in downtown Los Angeles had changed from a seller's market to a buyer's market during the previous week. He believed that the perception of tightness in the market had shifted, leaving owners more likely to make concessions.

In the early 1990s, most office and hotel markets were considered a buyer's market. Yet, even with a 20 percent overall vacancy rate, many office markets had virtually no blocks of space that could accommodate users looking for more than 50,000 square feet of contiguous space. While this tightness was confined only to a small number of large space users, it was the beginning of the end of the perception that the office market glut would exist forever.

At the beginning of a downturn, after the emergence of a buyer's or tenant's market, many projects already in the pipeline (i.e., those with financing commitments and entitlements in place but not necessarily under construction) will proceed. Because it can take two or more years to complete a major office or hotel project after securing the necessary commitments, the pipeline will dump a significant amount of product on the buyer's market when least needed or wanted.

The same lead time factor works during an upturn. Once a seller's market returns along with declining vacancies and increasing rents, developers will need nearly three years to deliver new office or hotel space. The pipeline for delivery of new rental apartments or industrial parks, however, can be much shorter. Stick-frame two- and three-story rental apartments take 12 to 15 months to complete once the financing and entitlements are in place. Industrial buildings can be completed in approximately six months.

During the most overbuilt period of the early 1990s, variation in lead times by product type resulted in vacancy rates for rental apartments (12

percent nationally) and industrial parks (9 percent nationally) that were much lower than for office projects (19 percent nationally). Hotels, which also require a two- to three-year lead time, were more overbuilt than any other income property type (61 percent occupancy; 65 percent is the theoretical break-even point).

Unbridled Optimism

The fourth reason for the extreme cyclical nature of the industry is the unbridled optimism of developers. When starting a new project during the mature phase of the cycle, developers have repeatedly shown their ability to justify projects without adequate market support—even in the face of significant overbuilding and the emergence of a buyer's market. Developers are masters in devising such rationalizations as

- the building will fit an underserved market niche that no one else has recognized;
- the project will be delivered just in time to take advantage of a "window of opportunity"; or
- the firm's marketing ability is far superior to that of the competition.

Assuming that financing is available, these rationalizations ensure that developers will build projects regardless of market conditions. Of course, this logic is reinforced by the fact that most developers are just that, developers. They only know how to build. So even when the market does not want new development, developers tend to ignore reality, rationalize, and build anyway.

For example, in 1985, an office developer in the Southwest was planning a 400,000-square-foot tower in a prestigious but overbuilt suburban market of a major metropolitan area. Naturally, he knew that the market was overbuilt—the vacancy rate was over 20 percent—but he felt the rate would decline substantially by the time his project was ready for occupancy. The fact of the matter was that the developer had a $4 million overhead. He needed the project's development fee to help offset a large portion of his overhead for the two years of planning and construction. The developer hoped that the market would correct itself in time. It did not. The building and the development firm were dragged down by the decision to proceed, and the suburban market was even further overbuilt, hurting everyone else in the market.

Understanding the Real Estate Cycle

The best way to demonstrate the extreme cyclical nature of the income property real estate industry is to look at individual metropolitan econo-

mies. In our postindustrial economy, metropolitan areas are the fundamental building blocks of the national and international economy. Each metropolitan area has a unique economy that is the product of a specific set of "export" industries, all of which sell goods and services outside the metropolitan area and bring new cash into the regional economy.

Export industries are the catalyst for all job growth in the metropolitan area. And job growth is the major determinant of demand for most income property product types. The extreme cyclical nature of the income property industry is vividly shown by comparing construction employment and the performance of various real estate products in a metropolitan area, as measured by office absorption, to general economic indicators for that region, as measured by overall job growth.

The three metropolitan areas examined below demonstrate the dramatic overreaction of the income property real estate industry when local economies undergo recessions and expansions.

Washington, D.C.

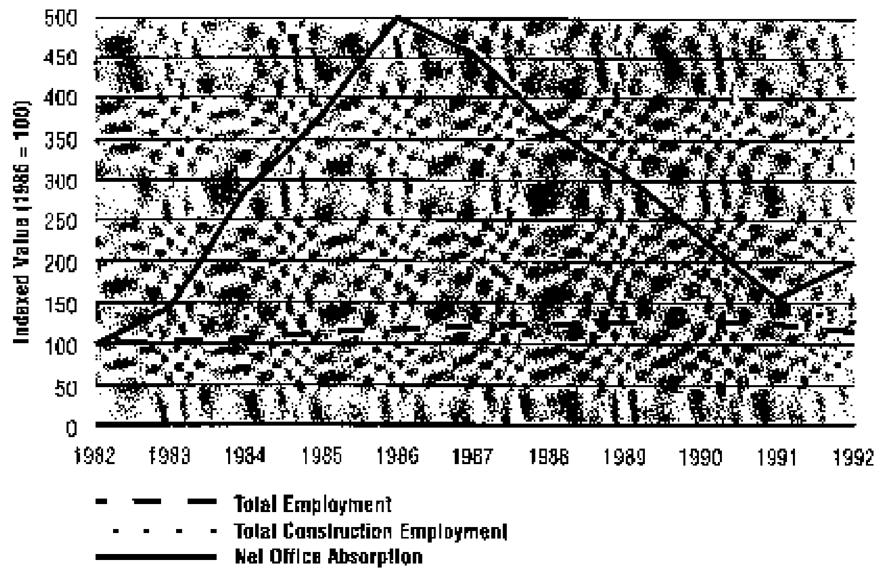
Before the 1980s, the Washington, D.C., metropolitan area was not known as a "boom town." Like many state capitals, the nation's capital did not undergo periods of extreme high growth, but it did not experience severe recessions either. As a consequence, the Washington real estate market was not subject to the wild swings that nearly every metropolitan area experiences during a recovery and subsequent recession. All of that changed in the 1980s: Washington, D.C., exploded.

The metropolitan area transformed itself from what was perceived to be a sleepy government town into an economic powerhouse. The continued growth of government; the need for subcontractors to cluster near specific government agencies (defense industries in Fairfax County, Virginia, close to the Pentagon, and medical companies in Montgomery County, Maryland, close to the National Institutes of Health); the emergence of the metropolitan area as a major business headquarters location (Mobil Oil, for instance); the recognition that trade organizations had to locate in Washington to ensure their effectiveness; and the development of a critical mass of cultural institutions, places of entertainment, and restaurants all contributed to the evolution of Washington, D.C., during the 1980s into one of the most dynamic economies and real estate markets in the country.

As Figures 1-1 and 1-2 show, employment in the metropolitan area grew by 36 percent from the 1982 economic trough caused by the early 1980s recession to the peak in 1990. The rate for the nation as a whole was 23 percent. Yet construction employment for the same period grew by 104 percent, 2.9 times as fast as total job growth. Even more impressive, office absorption during the peak years between 1985 and 1988 increased by

Figure 1-1

Employment and Net Office Absorption Trends in Metropolitan Washington, D.C., 1982–1992



Source: Robert Charles Lesser & Co.

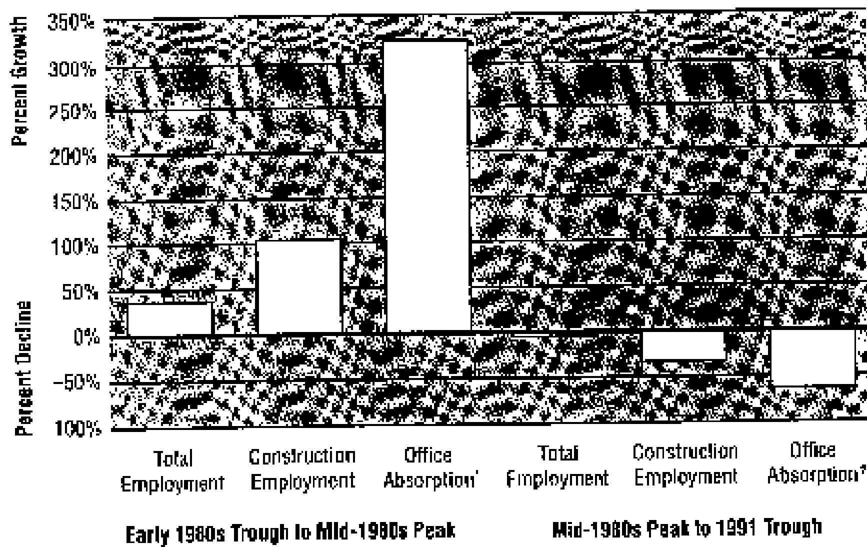
326 percent over the 1982 trough, a rate nine times the growth in total employment. The Washington, D.C., real estate market experienced one of the largest increases in office leasing activity of any metropolitan area in the country during a decade that saw more development in the United States than in any nation in recorded human history.

However, the recession in the late 1980s and early 1990s triggered a severe real estate industry overreaction. From the economic peak to trough, the Washington metropolitan area lost 4 percent of its jobs. Construction employment dropped by 34 percent, which was over eight times the rate of general job loss. And office absorption fell by 63 percent to 5.9 million square feet or by over 16 times the rate of general job loss.

Unfortunately, many long-time Washington, D.C., area development companies firmly believed that the region's real estate market could not experience a severe fall in activity and value simply because it had never before happened. These companies overextended themselves on commer-

Figure 1-2

Trough-to-Peak and Peak-to-Trough Analysis for Metropolitan Washington, D.C., 1982–1992



[1]Average of the four highest consecutive years in the mid-1980s compared to the 1982 trough for office absorption.
[2]Average of the four highest consecutive years in the mid-1980s compared to the 1991 trough for office absorption.
Source: Robert Charles Lesser & Co.

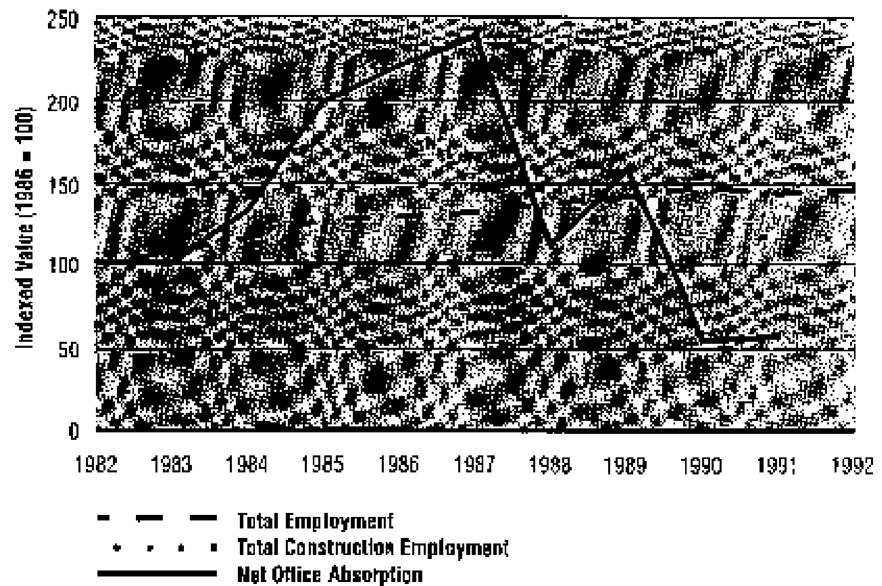
cial and residential land positions and, in particular, started new office projects that, once begun, could not be stopped. Most of these companies lost most of the net worth that they had accumulated during the 1980s and several went out of business.

Phoenix

The Phoenix economy is generally difficult for outsiders to understand. The Phoenix metropolitan area experienced a 50 percent increase in employment from the 1982 trough to the 1990 peak, placing it among the three fastest-growing metropolitan areas in the country for the same time period. While obvious industries such as state government and tourism are the foundation of the Phoenix economy, they do not by themselves

Figure 1-3

Employment and Net Office Absorption Trends in Metropolitan Phoenix, 1982–1992



Source: Robert Charles Lesser & Co.

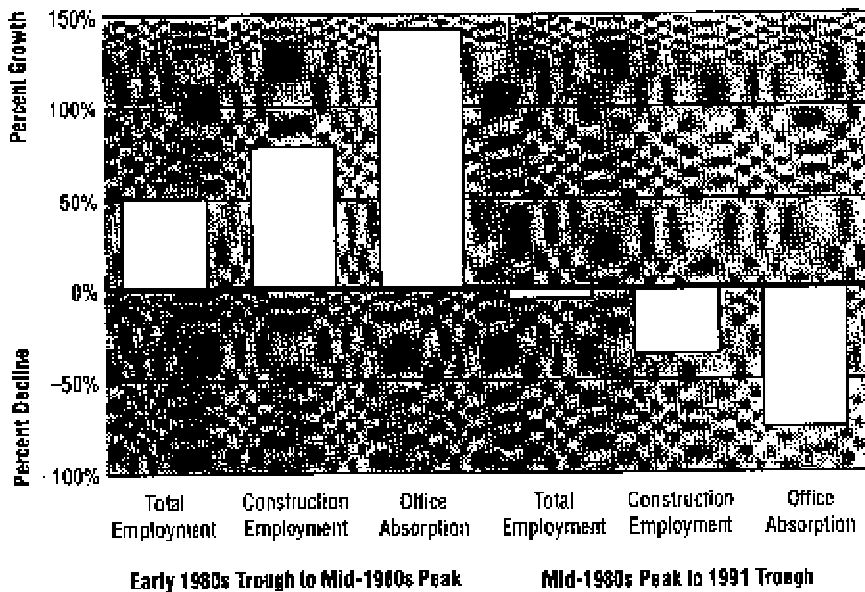
explain the extraordinary growth in jobs during the past decade. It has been the influx of retirees who bring their home equity and retirement income that has fueled the Phoenix economy. The influx is as clean an "industry" as there is and requires little in the way of extraordinary government expenditures on, for example, schools.

As Figures 1-3 and 1-4 show, the explosive growth in employment led to an overreaction in the real estate industry in both the boom years of the early to mid-1980s and during the economic slowdown that started locally in the late 1980s. Construction employment increased by 79 percent from its trough to its peak or by a rate over 1.5 times as fast as total employment growth. Even more of an overreaction occurred during the upturn as office absorption increased by 143 percent from trough to peak for a rate nearly three times as fast as the job growth rate.

As employment growth leveled off and declined slightly in the early 1990s, the real estate market collapsed. While the number of jobs declined

Figure 1-4

Trough-to-Peak and Peak-to-Trough Analysis for Metropolitan Phoenix, 1982–1992



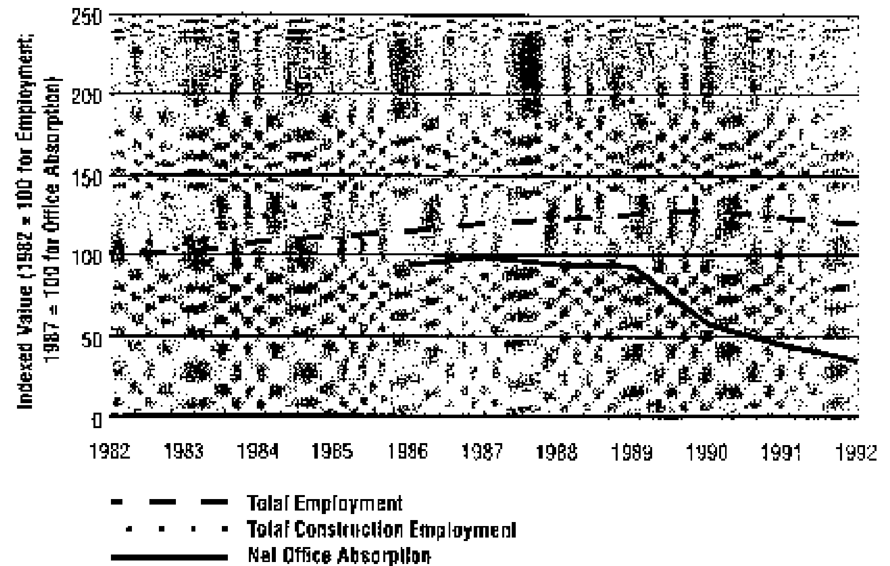
Source: Robert Charles Lesser & Co.

by only 0.5 percent from the peak year of 1990 to the probable trough in 1992, construction employment was off by 35 percent from the mid-1980s peak and accounted for 70 times as much as the drop in total employment. Office absorption was off by 74 percent from the peak to trough years, representing 148 times as much as the total employment drop.

While a mild recession plagued the Phoenix metropolitan economy, a deep depression hit the real estate industry. The extent of overbuilding in the market was about as great as that experienced by any metropolitan area in the country. The overbuilding was partly the result of the unrealistically high expectations of continued growth that characterized most of the 1980s. In addition, an influx of outside development and investment capital flowed into the metropolitan area, particularly from the Midwest and abroad. That capital was generally less sophisticated and came into Phoenix after the market had experienced boomlike conditions, thus further overheating the market.

Figure 1-5

Employment and Net Office Absorption Trends in Metropolitan Los Angeles, 1982–1992



Source: Robert Charles Lesser & Co.

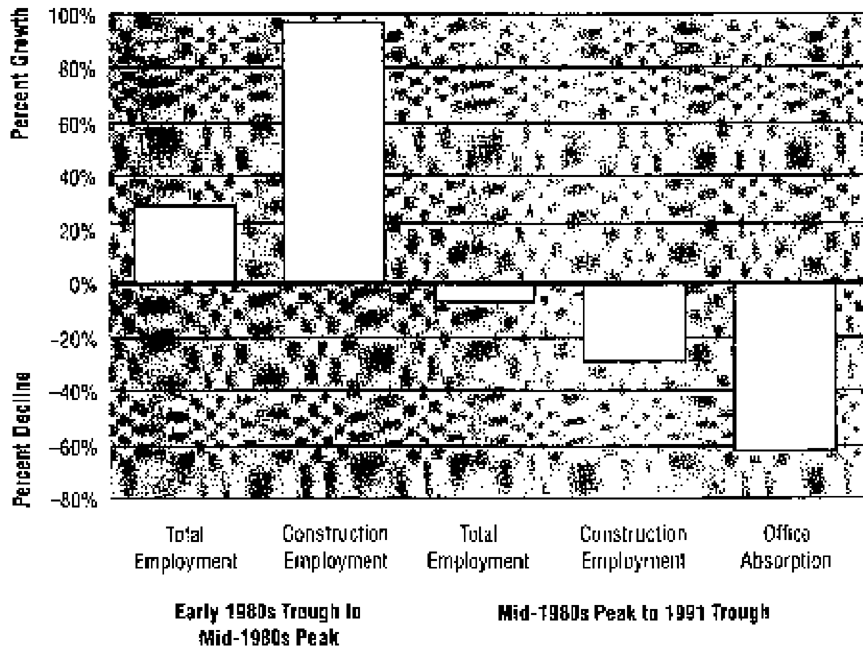
Los Angeles

The Los Angeles metropolitan area, accounting for such industries as aerospace, defense, high-technology research and development, entertainment, oil, apparel, world trade, and many others, is possibly home to the nation's most diversified economy. The Los Angeles region added more jobs in absolute terms in the 1980s than any other metropolitan area: over 1.4 million from the 1982 trough to the 1990 peak or an average of 180,000 new jobs every year. Yet even powerful Los Angeles is not immune to real estate depressions as dramatically demonstrated during the early 1990s.

Figures 1-5 and 1-6 show that, in the 1980s boom years, Los Angeles experienced a 29 percent increase in jobs, starting from a base of nearly 5 million in 1982 and peaking at nearly 6.5 million in 1990. While office absorption figures for the early part of the decade are not available, construction employment increased by 97 percent, a rate more than three times as fast as job growth.

Figure 1-6

Trough-to-Peak and Peak-to-Trough Analysis for Metropolitan Los Angeles, 1982–1992



Source: Robert Charles Lesser & Co.

Demonstrating that what goes up must come down, the decline in the number of jobs from the 1990 peak to the middle of 1992 was a little over 6 percent. However, construction employment decreased by 28 percent, nearly five times as much as the total employment drop. The decline in net office absorption was even greater. It fell 61 percent from the 1987 peak, when it absorbed 11.8 million square feet, to an annual absorption rate of only 4.6 million in 1992.

The enormous Los Angeles economy will undoubtedly recover after restructuring a number of its key industries, including aerospace and defense. With the resumption of growth, the real estate market will certainly rebound, perhaps a little wiser than before. The belief that Los Angeles is safeguarded against punishing recessions has been put to bed, at least for now.

Industry Roles

While national and regional economic ups and downs fuel the extreme cyclical nature of the income property industry, a vast array of industry roles, each with its own risks and rewards, contributes to and is affected by these extreme cycles.

Industry roles may be divided into two major categories based on the risk that the player assumes: capital risk and operating risk. Figure 1-7 outlines these roles and the subcategories within them. The clear boxes designate capital risk roles, and the shaded boxes designate operating risk roles or, as they are also termed, service businesses.

The player that assumes capital risk has general partner equity ownership in a project. As a rule, this individual or entity is the last in line to be rewarded for the successful completion of the industry role or roles performed and is usually the first to be "squeezed out" of ownership when unexpected problems cause financial setbacks. The capital risks may be so large as to imperil or bankrupt the player, no matter how strong the player's balance sheet—as has been shown repeatedly in the aftermath of the 1980s with Trump, Portman, Equitable Life, many Japanese investors, and even once-powerful Olympia and York.

During the performance of the capital risk role, the capital risk player may receive periodic income in the form of, for example, a development fee or acquisition fee. However, the player receives most of the revenues only at the back end after performing the role and either passing the capital risk on to another capital risk player (similar to the children's game "hot potato") or refinancing if the project has accumulated sufficient value.

The risks and rewards of the various capital risk roles vary greatly. As a rule, the risks and rewards increase with proximity to the source of supply—the land. Land speculation is potentially the most profitable capital risk role in the industry, but it is also the most risky.

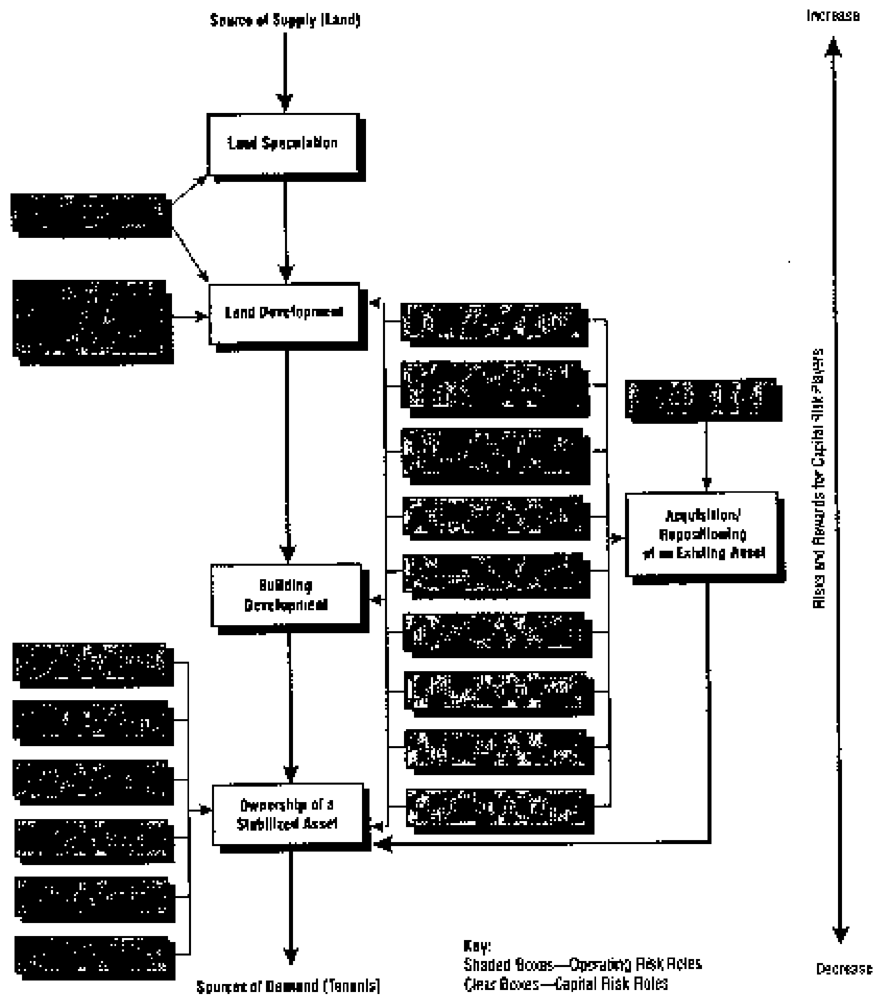
For example, one of the most spectacular real estate success stories in the Washington, D.C., metropolitan area during the 1980s boom years was a firm that specialized in land speculation and, occasionally, land development. The firm controlled a significant amount of the city's industrial, office, and residential land, which other developers subsequently developed between 1985 and 1988. Unfortunately, the company, believing that the good times would never end, permitted itself to become overleveraged with illiquid, cash-consuming land. When the market collapsed in 1989, the firm declared bankruptcy.

On the other hand, many land speculators and developers, properly financed and perceptive about the right time to buy and the right time to *stop* buying, did well in obtaining land during the early 1980s trough. During the early 1990s trough, many well-capitalized residential land devel-

opers and builders took land positions that will assure them a low basis during the hoped for residential upturn. Some industrial land developers also began to position themselves in the early 1990s by buying land at a fraction of the 1980s peak prices.

Figure 1-7

Real Estate Industry Roles



Source: Robert Charles Lesser & Co.

The player that assumes operating risk performs one of a myriad of service businesses for capital risk players. The major risk is associated with collecting the fees for performing the services. This is the working capital risk, which represents a far lower level of risk than that assumed by the capital risk player. Assuming that the service provider has many clients and no one client has a significant percent of the service provider's business, the damage of not being paid by any one client can be minimized, thus lowering overall risk.

The only other major risk for a service business is a lawsuit for faulty advice or service. While this risk has increased over the past 20 years—particularly for general contractors, design professionals, and accountants—it is manageable for most other service providers.

Of course, many industry players perform both capital risk and operating risk roles within their companies. Chapter 3 explores these two major industry roles in more detail.

With this understanding of the importance of the real estate cycle in the formulation of company strategy and an overview of the different roles and service businesses available to players in the industry, it is important to understand the principle of strategic balance for a real estate company, the subject of the next chapter.